

Chapter 7

INDUSTRY-SPECIFIC SUBSIDIES, TAX SHELTERS, AND OTHER TAX ISSUES

I. Introduction

Over the course of the last 70 years, the income tax has been riddled by special tax preferences and subsidies for certain industries and activities. These special rules have no place in a comprehensive income tax. This chapter discusses the Treasury Department's proposals to modify or eliminate most of these subsidies. In addition, this chapter discusses proposals that will improve the rules for measuring income, require more consistent accounting of receipts and expenses, and further reduce the opportunities for tax shelters.

Two large sectors of the economy -- natural resources and financial institutions -- have special tax rules that are inconsistent with both a comprehensive income tax and the goal of increased reliance on the market allocation of investment and saving. To ensure that saving and investment in the economy are channeled to their most productive uses, these sectors should be accorded tax treatment similar to that of other businesses.

The tax exemption of interest on debt of state and local governments is inconsistent with a comprehensive income tax. Nonetheless, to the extent that the exemption is confined to governmental activity, it has come to be an accepted part of the fiscal landscape. In recent years, however, state and local governments have expanded the use of tax-exempt bonds in ways which are often abusive and which compete directly with both government purpose issues of State and local governments and private financial intermediation. The proposal will repeal the use of tax-exempt bonds for nongovernmental purposes and tighten restrictions that prevent state and local governments from earning arbitrage profits.

The general income measurement rules proposed will greatly reduce the attractiveness of existing tax shelters. Yet opportunities for tax shelters may remain, and the Treasury Department proposes tightening provisions designed to prevent taxpayers from borrowing to invest in tax-preferred assets or from taking deductions that exceed the amount of funds "at risk."

The Treasury Department proposals will retain the basic system of U.S. taxation of international transactions. The reduction in the corporate tax rate necessitates changing the foreign tax credit to apply on a country-by-country basis. Source rules should be modified to reflect more closely the economic substance of transactions. The possessions tax credit will be revised to direct the credit to employment-producing investment by U.S. corporations.

Finally, the Treasury Department proposals will unify and simplify the taxation of estates and gifts, simplify the administration of penalty provisions, and allow certain provisions to expire. In addition, the proposals would have beneficial indirect effects on the financial solvency of the social security system.

II. General Issues of Income Measurement

The current tax law does not account satisfactorily for the timing of many receipts and expenses. Too frequently, taxable receipts can be deferred until later years and deductible expenses can be accelerated. This mismatching of receipts and expenses results in tax deferral, and the Federal Government effectively provides to the taxpayer an interest-free loan equal to the deferred tax liability. The value of tax deferral is greater, the longer the deferral and the higher the taxpayer's marginal tax rate. Table 7-1 indicates how much tax deferral reduces effective tax rates. For example, at an 8 percent after-tax interest rate, a 10-year tax deferral effectively reduces a 50 percent marginal tax rate to only 23 percent.

Several general income measurement rules in current law require modification in order to eliminate opportunities for tax deferral. The matching of receipts and expenses for activities extending over several years (multiperiod production) requires more comprehensive and more uniform cost capitalization rules. The use of the cash method of accounting should be available only to businesses that do not use the accrual method for financial accounting purposes, carry no inventories, and are too small to have access to professional accounting expertise. Vendors should not be permitted to report sales income on the installment method when their receivables are effectively converted into cash. The deduction for bad debt losses should be restricted to the actual losses experienced in the current year. Once these and other income measurement changes have been fully implemented, the retention of the corporate minimum tax will be unnecessary because the underlying tax preferences will have been eliminated.

A. Multiperiod Production

Activities that involve multiperiod production, or sales that occur in years after expenses are incurred, often benefit from the mismatching of expenses and receipts. For instance, most of the expenses involved in growing timber are deducted long before the timber is sold and payments are received. Any acceleration of deductions effectively shelters other income from current taxation. Matching of receipts and expenses is achieved if the costs of producing long-lived assets are capitalized, that is, included in the basis of the asset, and recovered when the asset is sold or depreciated.

Under current law, certain indirect costs, such as fringe benefits and the cost of borrowing to carry multiperiod production to completion, generally are not capitalized. In addition, the

Table 7-1

Effective Tax Rate Per Dollar of Income Deferred by a
50 Percent Taxpayer
for Different Deferral Periods and Interest Rates

Interest rate	: Deferral period (in years)					
	: 1	: 3	: 5	: 10	: 20	: 30
4 percent	48.1	44.4	41.1	33.8	22.8	15.4
6 percent	47.2	41.0	37.4	27.9	15.6	8.7
8 percent	46.3	39.7	34.0	23.2	10.7	5.0
10 percent	45.4	37.6	31.0	19.3	7.4	2.9
12 percent	44.6	35.6	28.4	16.1	5.2	1.7

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capitalization rules do not apply uniformly to all activities, and they vary depending on whether the output is sold or used in the producer's own business. Long-term contracts, self-constructed assets, inventories, minerals, and timber all have different cost capitalization rules. The Treasury Department proposals will make the cost capitalization rules more comprehensive and apply a uniform rule to all multiperiod production activities.

Making cost capitalization rules more uniform would ensure neutrality across types of businesses, reduce tax shelters, and improve equity. Uniform rules would eliminate the current tax incentive for businesses to construct their own plant and equipment, even when they are not the most efficient producers. In addition, due to the incomplete capitalization rules, industries with long production processes -- the so-called "natural deferral" industries, such as timber and minerals -- are dominated by tax shelter investors. Thus, current law results in serious dislocations and inequities. Among the many consequences, shelter investors bid up land prices and drive down product prices in these tax-favored industries; as a result, low-bracket individuals and businesses with little taxable income to shelter can no longer earn a sufficient after-tax rate of return from investments in these activities.

B. Use of Cash Method of Accounting

Allowing taxpayers to choose between cash and accrual accounting methods results in significant mismatching of taxable receipts and deductions. For instance, mismatching occurs in the case of prepayments of expenses when the buyer uses the cash method and deducts payments currently, but the seller uses a method of accounting that defers income until a later period.

The use of the cash method of accounting is not in accord with generally accepted accounting principles and, therefore, is not permissible for financial accounting purposes. Yet, many taxpayers that use an accrual method for financial accounting purposes choose to use the cash method for tax purposes solely because this method defers taxable income by accelerating deductions. The proposal will restrict the use of the cash method to businesses that do not use the accrual method for financial accounting purposes, carry no inventories, and have gross receipts of less than \$5 million.

The restriction on the use of the cash method would only affect businesses that are already using accrual accounting in some part of their business or are sufficiently large to have access to professional accounting expertise. The taxpayers that would be most affected by the proposal would be banks that use accrual accounting for financial reporting purposes, but the cash method for tax purposes, and large cash-method service organizations, such as accounting, engineering, law, and advertising firms.

C. Bad Debt Deductions

Taxpayers generally are not allowed to deduct the cost of future liabilities or losses. The deduction for bad debt reserves is an exception from the general realization principle that losses on an asset are not deducted until the sale or exchange of the asset. The current reserve deduction accelerates the timing of the deduction for bad debts, and thus allows businesses to defer tax on a portion of their income.

The current bad debt reserve rule allows taxpayers a deduction for actual bad debt losses in the current year plus any increase in the reserve. For example, a beginning firm with \$150 of loan losses might deduct \$250 in the first year: \$150 for the actual loan losses plus \$100 for an increase in the allowable reserve for future losses. As long as the firm's total loan losses never fell below \$100, the excess deductions would never be recaptured. Because firms effectively deduct their current loan losses, the accumulated reserve for a growing firm is never brought into taxable income. Indefinite tax deferral is virtually equivalent to tax exemption. Only firms that have declining loan losses are taxed on their deferred income. Thus, the current rule mismeasures the timing of taxable income, and provides differential tax treatment across types of firms. In addition, the current treatment of bad debt losses encourages debt financing for risky projects by reducing the risk premium that lenders charge.

The proposal will restrict the deduction for bad debts to the actual loan losses in the current year. This will eliminate the preferential tax treatment of risky loans and treat bad debt losses consistently with other types of losses.

D. Installment Sales

The tax system is not neutral with respect to the form of financing of property sales. The current rules for taxation of installment sales allow taxpayers that can afford to provide seller financing to defer tax liability on the sale of property. In contrast, sellers that receive cash directly, or whose sales are financed by a third party, pay tax on the gain currently. Charging interest on the amount of the deferred tax liability for taxpayers electing the installment method would make the tax law neutral as to the financing of property sales and would end use of installment sales as a vehicle for tax deferral.

The Treasury Department does not propose charging interest on installment sales, however, because of the increased complexity and taxpayer perception problems that such an approach would create. Most taxpayers would not readily comprehend why they should pay interest on the deferred taxes when the taxes are only paid as installment payments are received.

The installment sale method originally was intended to alleviate the seller's liquidity problems. The method is now commonly used to defer tax liability on gain from sales by individuals and businesses that have no liquidity problems. For example, sales income may be reported on the installment method, even though the installment notes received are immediately pledged as collateral for loans. In such cases, the seller has received cash immediately, has no liquidity problem, and is simply using the installment method for tax deferral. The Treasury Department proposes to deny use of the installment sale method in such circumstances.

E. Corporate Minimum Tax

Minimum taxes reflect an attempt to maintain the equity and neutrality of a tax system that is riddled with special preferences. The corporate minimum tax would be necessary only if the underlying special preferences were retained. Because the Treasury Department's comprehensive tax reform package repeals almost all special preferences directly, eventual repeal of the corporate minimum tax would be possible. However, the minimum tax should not be repealed unless and until the basic reforms are fully implemented.

If, after enactment of tax reform, individuals and corporations with significant economic income still find mechanisms by which to pay little or no income tax, the Treasury Department would support the enactment of appropriate minimum taxes on the economic income of individuals and corporations.

III. Subsidies for Specific Industries

A. Energy and Other Minerals

Proper measurement of income in natural resource industries requires that costs of exploration and development be capitalized. Such expenses should then be recovered over the productive life of a natural resource property as resources are extracted and income is earned. The proper recovery of exploration and development costs is achieved through cost depletion; it is analogous to economic depreciation. Where only "dry holes" occur and an entire property is abandoned, the related costs should be written off at the time of abandonment.

Taxation of natural resources in general, and of oil and gas in particular, has long deviated from principles required for the accurate measurement of income. The energy industry is currently favored over other business activities through the tax system in two unique ways. First, "intangible drilling costs" -- the expenses of drilling, other than for the purchase of physical assets -- can be deducted currently even if drilling is fruitful. This acceleration of cost recovery produces several adverse effects. Investment in oil production is favored relative to other investments with higher pretax returns. Drilling is favored relative to less expensive means of exploration that are not tax-preferred. Investment in energy sources

where capital costs are a relatively high share of total costs are favored relative to others. Tax burdens on energy corporations and on individuals investing in the energy sector are reduced, interfering significantly with tax equity. As a result, the perception of fairness of the tax system is tarnished.

Second, except for major integrated oil companies and certain large independent producers, cost depletion is not required for those costs of exploration and development that are not written off immediately. Instead, qualified producers of petroleum and all producers of certain other natural resources are allowed to deduct from taxable income a flat percentage of gross income (ranging from 5 to 22 percent, depending on the mineral), subject to a limitation that the deduction cannot exceed 50 percent of net income from the property. Deductions based on percentage depletion, plus previously deducted investment costs, generally exceed 100 percent of actual costs of exploration and development. Thus, percentage depletion is not merely an accelerated alternative to cost depletion as a means of recovering investments in natural resources; rather it is a subsidy to the exploitation of natural resources that is administered through the tax system. This subsidy increases with the prices of natural resources. Percentage depletion encourages over-production of scarce domestic resources, adds complexity to the tax system, unfairly benefits owners of those resources, and erodes the perception of fairness of the tax system.

The oil industry is also subject to the windfall profit tax, a special excise tax on revenues from crude oil produced domestically. Taxable crude oil is classified in three tiers. Generally, oil in tier one is oil that has been subject to price controls; oil in tier two consists of stripper well oil; and oil in tier three is newly discovered oil, incremental oil and heavy oil. The tax base is the difference between a statutory base price and the amount for which the oil is sold, less a severance tax adjustment. The tax rate is highest for tier one oil and is progressively reduced for tiers two and three (with a greater reduction for newly discovered oil).

The windfall profit tax was enacted in 1980 at a time when crude oil prices were rising rapidly. Its enactment was associated with decontrol of crude oil prices. Since that time crude oil prices have moderated and, in fact, have significantly declined from record high levels. Consequently, the perceived "windfall" for producers has generally vanished. Furthermore, the tax offset some of the additional stimulus to domestic production provided by oil decontrol.

The goal of increased reliance on free-market forces underlies this Administration's energy policy, as well as the Treasury Department study of fundamental tax reform. As stated in the Budget for Fiscal Year 1985:

The Nation needs adequate supplies of economical energy. The most promising way to meet this need is to let market forces work ... The

primary role of the Federal Government with respect to energy is to establish and maintain sound policies based on economic principles that promote efficient energy production and use. This strategy ... emphasizes the importance of allowing our market economy to function to ensure that these decisions are as productive and efficient as possible.

The Treasury Department therefore proposes that the windfall profit tax be repealed and that the option of expensing intangible drilling costs and percentage depletion be replaced by cost depletion. Repeal of expensing on intangible drilling costs and percentage depletion should not be viewed as penalizing or singling out the energy industry. The proposed rules are identical to proposed changes in the general rules for income measurement for all multiperiod production, which require cost capitalization in order to match deductions with taxable receipts.

Some will argue that these subsidies for the production of minerals provided by special tax treatment cannot be eliminated, because doing so would reduce domestic production and increase American dependence on foreign sources of oil and other minerals. Further, they will argue that enactment of the Treasury Department proposals would raise prices of minerals, even though the magnitude of this effect would probably be small because the prices of most minerals are set in international markets. While these effects may occur and might be burdensome in the short run, the proposed reforms would be beneficial in the long run because the capital and labor released from the energy and minerals sector as a result of a more neutral tax policy would be employed more productively in other industries. Higher prices for oil and gas, lower marginal tax rates, indexation of the basis against which depletion allowances are taken, and repeal of the windfall profit tax would partially offset the elimination of the subsidy, cushion any drop in domestic production, and encourage the development of alternative domestic energy sources. As the Administration's announced policy on energy makes clear, the public would gain from a more rational allocation of resources among competing energy modes. Prices more reflective of the actual replacement costs of energy would encourage greater conservation, and that, plus less rapid depletion of domestic resources, would, over the long run, reduce vulnerability to foreign supply disruptions.

B. Financial Institutions

Most types of financial institutions presently benefit from preferential tax treatment. Besides being unfair and distortionary relative to the taxation of the rest of the economy, these tax preferences create distortions within the financial sector that are inconsistent with the Administration's efforts to deregulate financial markets. Equity and neutrality demand that all financial institutions be taxed uniformly on all of their net income. These special

preferences are especially inappropriate in a world in which the corporate tax rate is lowered and both individuals and other corporations are taxed on their economic income.

Banks and thrift institutions are allowed to deduct an arbitrary fraction of outstanding loans or otherwise taxable income as an addition to a reserve against bad debts, without regard to the actual losses they experience on bad debts. In theory, reserve accounting is consistent with accrual accounting; but in practice reserve accounting for banks and thrift institutions has borne little relation to expected losses, and therefore little relation to proper accrual accounting. The special bad debt deduction for thrift institutions is tied to specialization in residential mortgage lending, and only benefits profitable thrift institutions. The special rules are at variance with the general rules that are applied to non-depository institutions and the correct income measurement rule. This arbitrary deduction involves a tax subsidy for financial institutions that has no place in an income tax system; it should be repealed.

Taxpayers generally are prohibited from deducting interest on debt incurred to finance holdings of tax-exempt bonds. Banks benefit from an exception to this rule; they are able to deduct 80 percent of interest incurred to carry tax-exempt securities, and thus offset taxable income from other sources, in many cases totally eliminating income tax liability. Because of the special rule that allows banks to earn arbitrage profits, borrowing costs of state and local governments are subject to greater volatility because of the excessive demand created for their tax-preferred bonds. The Treasury Department proposes extending to banks the general rule that fully disallows interest deductions on debt incurred to carry tax-exempt securities.

Credit unions, which compete with banks and thrift institutions, currently are tax exempt. This exemption allows deferral of tax on members' interest income that is retained in the credit union. This tax break for their members gives credit unions a competitive advantage in attracting deposits from other financial institutions. The exemption should be repealed.

Life insurance companies traditionally have been allowed a deduction for increases in policy reserves that exceed the amount of policyholders' savings and interest income represented by the actual increase in the cash value of the policies they underwrite. In addition, they are allowed a special deduction for 20 percent of otherwise taxable income (60 percent for small companies). This extra deduction is equivalent to applying a lower tax rate to the income of life insurance companies. Deductions for increases in reserves should be limited to increases in cash value, and the special deduction should be repealed.

Amounts earned by policyholders on the cash value of life insurance (the "inside buildup") generally escape income tax under present law. As a result, income earned on investments in life insurance policies is treated substantially more favorably than

interest on deposits in banks and thrift institutions, which is taxed currently. In addition, tax-deferred income from annuities can be earned in unlimited amounts. In order to make the taxation of income flowing through financial institutions more neutral, the Treasury Department proposes that the exclusion of the inside buildup in life insurance be repealed and that annuity interest income be subject to current taxation. Taxpayers will be allowed to treat the savings portion of life insurance premiums as deposits in an individual retirement account (IRA), subject to the overall IRA limitations. Income earned on these savings will be tax exempt until withdrawn from the IRA.

Property and casualty (P&C) insurance companies are allowed a deduction for additions to accounts for protection against losses that bears no relation to actual losses. In addition, P&C companies are allowed current deductions for losses expected to be incurred in the future, with no recognition that the future losses are worth substantially less, in present value terms, than the deductions being allowed currently. (Another way of saying this is that to meet future losses a much smaller amount can be set aside today because of the interest earned before the loss is incurred.) Both of these excessive deductions are inconsistent with a comprehensive income tax; the first should be repealed, and the second should be altered to reflect the value of an early deduction for future losses.

The proposed tax changes at both the individual and corporate levels would make the "playing field" for financial institutions more level and more comparable to that of nonfinancial institutions. These changes are consistent with and necessary for the deregulation of the financial sector. All financial institutions would be affected, but they would generally be compensated by the reduction in the corporate tax rate.

Banks would no longer find it advantageous to eliminate Federal tax liability by investing in tax-exempt bonds; the lower tax rate would make their after-tax return on taxable investments generally higher than the current tax-exempt yields. Eliminating the special rule that enables many banks to pay little, or no, Federal income tax would improve the perception of fairness of the tax system. Repeal of the special deductions of thrift institutions and life insurance companies will be offset by the lower tax rate. Credit unions will be taxed on the same basis as banks and other thrift institutions. Individuals would buy life insurance and annuity policies for the primary purpose of protecting against premature death or longevity, rather than as a tax shelter. And P&C insurance companies would have no tax advantage in selling casualty insurance compared with companies willing to self-insure against the risk of property loss.

The total amount of saving flowing through financial institutions would increase as rate reductions increase the after-tax return to saving. The proposed changes would remove the tax distortions that encourage saving to flow through life insurance companies at the

expense of other financial institutions. The change in the bad debt deduction would remove the tax incentive for banks and thrift institutions to make risky loans.

C. Debt of State and Local Governments

Interest on debt issued by State and local governments for governmental purposes, such as schools, roads, and sewers ("governmental bonds"), has long been exempt from tax. The exemption of this interest is inconsistent with a comprehensive income tax. Moreover, the subsidy it provides to the borrowing of State and local governments is an inefficient one because much of its benefits are received by high-income bondholders, rather than producing cost savings for state and local governments. The exemption of interest on governmental bonds originated in earlier views about the fiscal relationship between the Federal and State and local governments under the Constitution. However outmoded that understanding of federalism may appear today, this exemption appears to be an accepted part of the fiscal landscape.

State and local governments have recently expanded the use of tax-exempt bonds in ways that should not be accepted. Proceeds from tax-exempt bonds have been used for non-governmental purposes: for economic development (via industrial development bonds or IDBs), for low-interest mortgages on owner-occupied housing, for student loans, and for private hospital and educational facilities. In addition, State and local governments have invested proceeds of tax-exempt bonds in higher-yielding taxable securities to earn arbitrage profits.

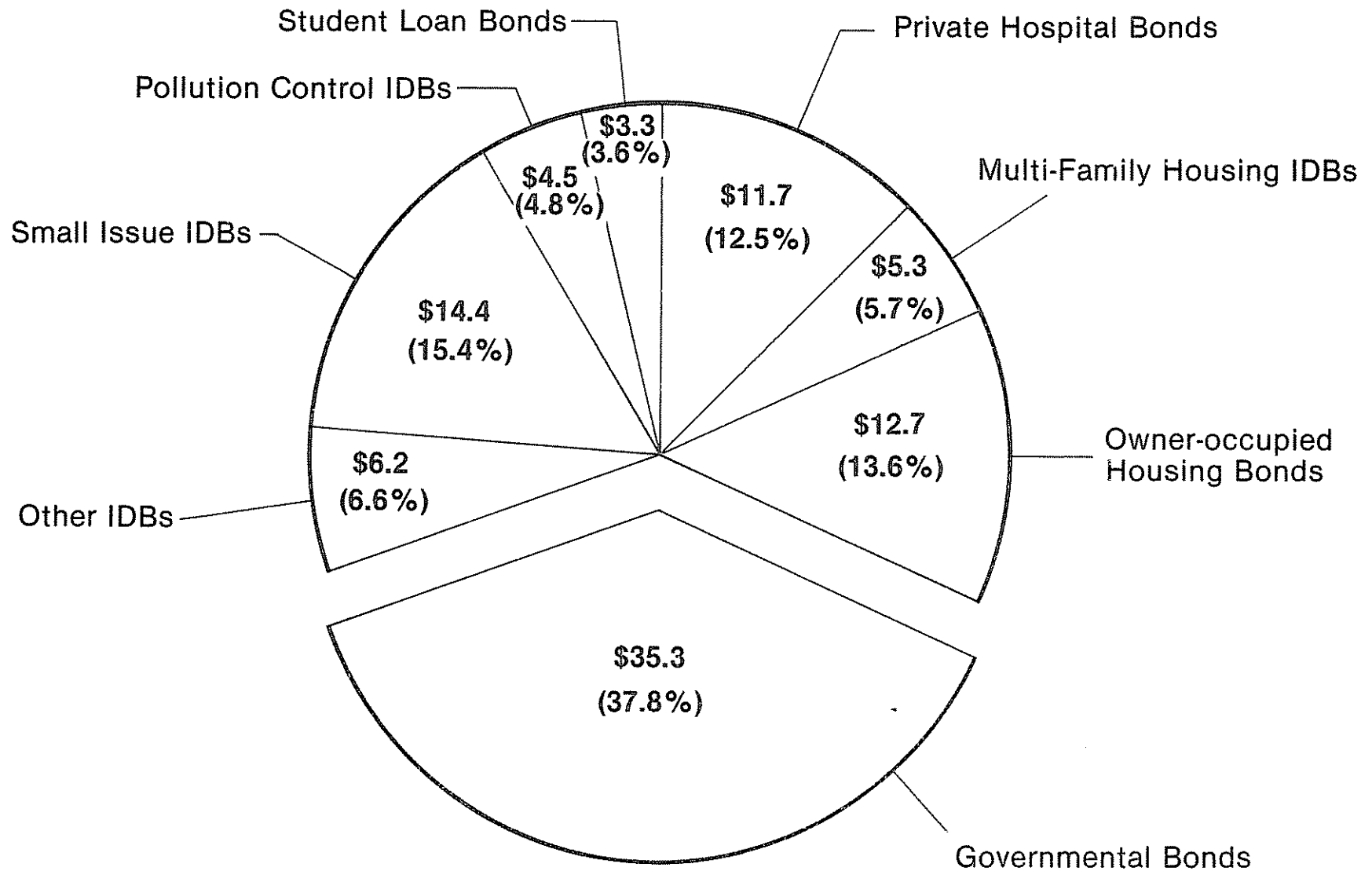
The use of State and local governments' tax-exempt borrowing privilege for the direct benefit of private businesses, nonprofit organizations, and individuals has increased rapidly in recent years. Non-governmental bonds issued in 1975 totaled only \$9 billion, accounting for 30 percent of long-term tax-exempt bond volume. In 1983, non-governmental tax-exempt bonds totaled \$58 billion and accounted for 62 percent all new long-term tax-exempt bond issues. (See Figure 7-1.) Despite recently enacted volume limitations on certain non-governmental bonds, their share of the total tax-exempt bond market will continue to increase in the future in the absence of further restrictions. This will bid up the interest rates that must be paid on debt of State and local governments issued for governmental purposes.

Seen from the perspective of any one State or local government, issuance of such non-governmental tax-exempt bonds appears attractive; a local business or resident obtains a Federal subsidy at no cost to the local government. In many cases the local government would not provide a direct subsidy to the same business or resident. From a national perspective, however, the subsidies provided through tax-exempt financing to private businesses and individuals are inefficient, costly and distortionary. If all of the States compete for economic development by issuing industrial development bonds, economic activity will not be significantly greater than in the

Figure 7-1

VOLUME OF LONG-TERM TAX-EXEMPT BONDS ISSUED IN 1983

(Amounts in \$Billions)



absence of the bonds and it will probably not be located very differently. Firms not benefitting from IDBs are placed at a competitive disadvantage. Moreover, the loans are not allocated to their best use, but rather to those who best know how to manipulate an administrative or political process.

The primary effects of non-governmental tax-exempt bonds are a lower interest rate for the private business or individual benefitting from tax-exempt financing, tax savings for wealthy bondholders, higher borrowing costs on tax-exempt bonds issued for governmental purposes, less Federal revenues as a result of tax exemption of interest on the bonds, and correspondingly higher tax rates on wages and salaries and other forms of taxable income. If below-market mortgages or student loans benefitting local residents are thought to be worthy of local support, they should be financed locally, not through inefficient Federal subsidies to local borrowing that drive up tax rates throughout the country. The Treasury Department proposals will eliminate the future issuance of all tax-exempt bonds resulting in proceeds used by persons or organizations which are not governments, tighten the restrictions on arbitrage, rely on market forces to direct private investment to its most efficient use, expand the tax base, and lower tax rates.

The proposed elimination of non-governmental bonds should be of financial benefit to State and local governments. Reducing the volume of tax-exempt bonds will improve the market for bonds issued for government purposes, thus reducing interest costs to governments.

D. Special Rules

In addition to the industry-specific subsidies previously described, the tax law is littered with credits, exclusions, and special exceptions to general rules. These implicit subsidies should be repealed as part of tax reform designed to free markets from the intrusions of government via the tax system.

Land is not depreciable because its productive capacity is not expected to decline measurably over time. Yet certain capital expenditures have special recovery rules, even though some of these expenditures are for assets similar to land. For instance, companies are allowed to recover the cost of railroad grading and tunnel bores over 50 years, even though such improvements may have undiminished economic value for hundreds of years or even indefinitely.

Other special rules were intended to encourage a particular activity by allowing accelerated write-offs and the advantages of tax deferral. The current law allows 5-year write-off of certified pollution control facilities. This provision was intended to reduce the cost of businesses complying with regulatory requirements. Since the enactment of ACRS in 1981, this provision has not been used, because accelerated cost recovery over 5 years is more generous than straight-line recovery over the same period. However, compared with the indexing and recovery over economic lives proposed for all other

assets, this special provision would be extremely advantageous. As part of comprehensive tax reform, these special rules that mismeasure economic income and benefit specific industries should be repealed.

The Merchant Marine Capital Construction Fund is an example of a tax subsidy program that has become outdated and distorted from its original purpose. In 1936, special tax treatment, along with direct appropriations programs, were provided for U.S. citizens owning or leasing U.S.-flag vessels to assure an adequate shipping capacity in the event of war. The direct appropriations programs have been phased out because an adequate number of vessels are owned or controlled by U.S. citizens, though perhaps registered elsewhere. The tax subsidy, on the other hand, has been expanded to fishing vessels and ships plying the inland waterways -- a result inconsistent even with the original, but antiquated, purpose for the Fund. This tax subsidy program should be repealed.

The R&E credit, which is designed to encourage businesses to undertake additional private research activities, will be extended. To improve the effectiveness of the credit, however, the scope of qualifying expenses will be focused so that the credit is available only for private research activities that are likely to lead to technological innovations. A revised definition of eligible expenses will target the credit more narrowly and provide a greater incentive for business to undertake research efforts which will lead to productivity-enhancing innovations.

The tax Code also contains a number of credits that should be repealed. Rehabilitation tax credits provide Federal subsidies for the renovation of older buildings and historic property. These tax credits were intended to match the favorable tax treatment of new buildings resulting from accelerated depreciation and investment tax credits. With repeal of the investment tax credit and the use of indexed, economic depreciation, the rehabilitation tax credits should be repealed. The subsidization of historic preservation expenditures, if believed to be desirable, should be provided through direct appropriations, rather than through the tax system.

IV. Further Curtailment of Tax Shelters

Participation in a variety of tax shelter investments has increased steadily since the 1960s. One indication is the growth in the number of individual tax returns claiming partnership losses, as partnerships are the most common vehicle for investing in tax shelters. Between 1963 and 1982 the number of taxpayers claiming partnership losses increased almost five-fold to 2.1 million. By comparison, the total number of tax returns filed during the same period increased by only 50 percent.

In 1981 and 1982, U.S. partnerships actually reported aggregate net losses for tax purposes. Over one-half of all partnership losses were concentrated in three broad areas: farming, mining and other extractive industries, and real estate. These industries benefit

especially from opportunities for sheltering created by the combination of deferral of taxes, preferential treatment of long-term capital gains, and the deductibility of interest.

Tax deferral arises whenever investors are able to accelerate deductions or defer reporting of taxable receipts. Opportunities for such deferral are created by a variety of tax rules. In the case of farms, current deductions are allowed for costs incurred to earn income which is not reported until a later taxable year; in the case of oil and gas drilling, intangible drilling costs may be expensed in the current taxable year, rather than capitalized and recovered over a number of years; in the case of real estate, deferral is made possible by tax depreciation rules which permit deductions in excess of true economic depreciation to be taken in the early years of the investment.

A second aspect of tax shelters is the conversion of ordinary income to tax-preferred capital gains. Tax deferral and conversion of ordinary income to capital gains occur together when accelerated depreciation deductions are used to offset ordinary wage and salary income, while a significant portion of the annual return on the investment is realized as preferentially taxed long-term capital gain at some future date.

Moreover, when taxation of income from an asset can be deferred or converted into tax-preferred income, investors will often have a strong incentive to finance the acquisition of the asset by means of borrowing, as this allows the investor to engage in interest-related tax arbitrage. Interest-related tax arbitrage transactions occur when an investor borrows funds, fully deducts the interest expenses incurred to borrow those funds, and then uses the funds to purchase investments which earn either partially or entirely tax-exempt or tax-deferred income.

It is the combination of tax deferral and leveraged financing which is the principal cause of the substantial losses reported by tax shelter partnerships in the aforementioned three industries -- some \$33 billion in 1982. Yet for reasons just mentioned, these "losses" overstate true economic losses incurred by those partnerships. A substantial portion of the accounting losses simply reflect preferential tax treatment of certain sources and uses of income.

As a consequence of these tax accounting losses, affluent investors are able to shelter other income from tax. This is undesirable primarily because preferential treatment of particular activities interferes with the market-determined allocation of resources and unfairly benefits investors in tax shelters.

The proliferation of tax shelters has other undesirable consequences. Auditing tax shelters absorbs valuable resources of the Internal Revenue Service that could better be devoted to other tasks. Beyond that, the widespread existence of legitimate shelters makes it far more difficult for the Internal Revenue Service to identify and

control abusive shelters involving tax fraud. Perhaps worse, unsophisticated taxpayers who cannot afford legal advice also cannot distinguish between legitimate and abusive shelters and thus increasingly invest in the latter with disastrous results. To lower and middle-income taxpayers who cannot benefit from tax shelters, the distinction between legal tax avoidance and illegal evasion may be too subtle to prevent a widespread impression that the tax system is unfair because high-income taxpayers are escaping taxation. This impression of unfairness lies at the root of many complaints about the tax system and undermines voluntary compliance with the tax law. Of course, this perception is accentuated by widely publicized stories about abusive shelters.

Growth in tax shelter activity has also played a significant role in the erosion of the Federal income tax base, particularly among affluent taxpayers. Estimates from the 1983 Treasury individual tax model indicated that total partnership losses (losses claimed by individuals -- as distinct from corporations, who also own partnership interests) may have sheltered as much as \$35 billion of all individual income from taxation. Roughly \$28.6 billion or 82 percent of total partnership losses claimed on individual tax returns were reported by taxpayers with gross incomes (before losses) of \$100,000 or more, and 60 percent, or \$21.0 billion, were reported by taxpayers with gross income (before losses) in excess of \$250,000. By comparison, these groups reported considerably smaller shares of all gross income before losses -- 9 percent and 4 percent, respectively.

Several of the Treasury Department's proposals -- for example, lower tax rates, taxation of real capital gains as ordinary income, capital consumption allowances that approximate economic depreciation, indexing of interest expense, matching expenses and receipts from multiperiod production, and tax treatment of certain large partnerships as corporations -- will greatly reduce the attractiveness of tax shelters. Yet opportunities for tax shelters will remain. The proposals in this section will further reduce these opportunities.

A. Limiting Interest Deductions

Under the present income tax, certain forms of investment income are not fully taxed. Notable examples include interest from State and local securities, long-term capital gains, and the earnings on many insurance and retirement accounts. Moreover, certain expenditures give rise to deductions and credits that can be used to offset tax that would otherwise be due on other income. The most important of these are accelerated depreciation, the investment tax credit, and the immediate deduction for intangible drilling costs.

When investments benefitting from tax preferences are debt-financed, the preferences generally are magnified. This problem has long been recognized, and since 1921 deduction of interest incurred to carry tax-exempt securities has been disallowed. Because it is difficult for the Internal Revenue Service to associate a particular debt with investment in tax-exempt securities or other tax-preferred

investments, this type of restriction is not fully effective. More recently, the deduction for investment interest expense was limited to the sum of investment income plus \$10,000, in order to prevent taxpayers from taking large deductions for interest expense incurred to earn tax-preferred income. However, the limitation does not adequately take into account interest incurred to finance investments in many tax-preferred activities.

The Treasury Department proposes tightening the interest limitation rules. Individuals would be allowed no current deduction for investment interest expense in excess of the sum of passive investment income, mortgage interest on the taxpayer's principal residence, and \$5,000. For this purpose, passive investment income will not include business and investment income from general partnerships interests, sole proprietorships, S corporations actively managed by the taxpayer, and farms, but will include dividends, interest, and income from limited partnership interests. Similarly, investment interest subject to the limitation will include all interest now deducted as an itemized deduction (other than interest on the taxpayer's principal residence) plus the taxpayer's allocable share of interest incurred through any limited partnership interest and any S corporation in which the taxpayer is a passive investor. This limitation will not prevent the deduction of mortgage interest on the principal residence of the taxpayer, nor the deduction of interest incurred in the conduct of a trade or business. The \$5,000 allowance would prevent the limitation from affecting most taxpayers.

As long as high-income investors are able to borrow funds to acquire investments which pay tax-preferred income, and deduct currently the interest expenses incurred to borrow those funds, tax equity will suffer and the marginal tax rate needed to raise a given amount of tax revenue will be higher than would otherwise be required. Moreover, the arbitrage availability encourages high-income investors to compete aggressively for borrowed funds in capital markets, reducing the supply of capital available for low-income borrowers, including prospective homeowners and new businesses. The proposed limitation on interest expense would reduce the extent to which high-income investors engage in tax-motivated borrowing, but would not discourage borrowing for active business pursuits. This would both lower marginal tax rates, and make it easier for moderate-income investors to compete for borrowed funds with high-income investors.

B. At-Risk Rules

Current law contains rules to prevent a taxpayer from taking deductions that exceed the amount he or she has "at risk" in a given investment. The at-risk rules apply primarily when the taxpayer is taking deductions related to assets that are heavily financed by non-recourse debt -- debt for which the taxpayer is not personally liable. Non-recourse debt often plays an important role in tax shelters, as it permits taxpayers to report deductions in excess of the amount of the taxpayer's actual investment. The tax losses that these deductions produce for the investor are clearly artificial, since an investor

cannot possibly lose more than he or she has at risk in an investment.

Because the at-risk rules are complicated, it is tempting to propose that they be eliminated in the interest of simplification. But the at-risk rules could not be repealed without replacing them with an equally effective solution, such as a reduction in the basis used in calculating depreciation allowances by the amount of non-recourse debt. Such a radical departure from current law would have an uncertain and perhaps severe economic impact. Thus despite the logic of such an approach, the Treasury Department does not propose it. Rather, the at-risk rules should be retained and applied to all investments.

In the case of activities to which the at-risk rules do not currently apply, such as real estate and leasing, the tax benefits of the investment are so magnified that the true economic return of the investment property is often a minor consideration in the ultimate decision of whether to invest. As a result, resources are allocated without due regard to the true (pre-tax) profitability of such ventures. Since pre-tax profitability can generally be trusted to guide the nation's resources to their best uses, this emphasis on after-tax profits, to the neglect of pre-tax profits, interferes with the market allocation of resources to their most productive uses.

Extending the at-risk rules to cover all activities would allow deductions only to the extent of the investor's actual liability for potential losses in that activity. As a result, investors in tax shelter activities could still claim sizable depreciation and interest deductions, provided that they were accountable for a commensurate share of the business risk associated with the investment. This would cause investors to pay more attention to the potential economic gain or loss from investments, rather than focusing on their tax consequences, and thereby promote greater efficiency in the allocation of the nation's capital among competing activities. With investments based on economic realities, there would be less tendency for real estate prices to spiral upwards, driven by investors in tax shelters.

V. International Issues

In taxing the foreign income of U.S. taxpayers, the United States has sought a balanced treatment of foreign and domestic investment, tempered by concern for international competitiveness. U.S. taxpayers are subject to tax on their worldwide income. However, in order to avoid double taxation of foreign income also taxed by host countries, a credit is allowed for foreign income taxes paid. In the interest of competitiveness, U.S. tax on income earned by foreign subsidiary corporations is generally deferred until that income is remitted to U.S. shareholders. (This tax deferral is not available with respect to tax haven income.) In addition, the Foreign Sales Corporation ("FSC") provisions and the exclusion of individuals' foreign earned income provide special rules to promote exports. Other special rules are designed to promote investment in the U.S. possessions.

The Treasury Department proposals will retain this basic system of U.S. taxation of international transactions. For example, the foreign tax credit, the deferral of tax on undistributed foreign subsidiary earnings, the FSC provisions, and the foreign earned income exclusion would be retained. The present system of current taxation of certain tax haven earnings of foreign subsidiaries also would be continued, but consideration should be given to coordinating the various rules. Changes would be made in the foreign tax credit limitation and in certain source provisions to make those rules work more efficiently and equitably. The taxation of income from the possessions and territories would be revised. Other more technical changes would rationalize the taxation of U.S. branches of foreign corporations and the translation of certain foreign exchange transactions.

The foreign tax credit is intended to prevent the U.S. tax from resulting in double taxation of foreign income. It is not intended to reduce the U.S. tax on U.S. income. To prevent credits for high foreign taxes from offsetting the U.S. tax on domestic income, a limit is placed on the amount of foreign tax credit which may be used in any given year (with provision for carryover of excess credits). Current law generally limits the allowable foreign tax credit to the U.S. tax on the taxpayer's aggregate foreign source income. Under this "overall" limitation, foreign income taxes paid to different countries are averaged together; high foreign taxes paid to one country may be used by the taxpayer to offset the U.S. tax on income earned in a low tax country.

Such an approach distorts investment decisions. A taxpayer has an incentive to generate low-taxed foreign income to utilize excess foreign tax credits. As a consequence, investments may be shifted from the United States to low tax countries. The U.S. tax base is eroded and capital may be allocated to less productive uses for tax reasons. Low-taxed foreign income also may be generated by using the existing source rules simply to shift income to low-tax jurisdictions. For example, income from certain sales may be sourced in any country by having the title pass there.

The proposed reduction in the U.S. corporate tax rate will greatly increase excess foreign tax credits. This will correspondingly increase the incentives to divert investment and income to low-tax countries, if the overall limitation is left intact. It is therefore proposed that the foreign tax credit limitation be changed to apply country by country, and that certain source rules be modified to reflect more closely the economic substance of the transaction.

There are those who will argue that the Treasury Department proposal will only aggravate the problem of excess foreign tax credits. But this defense of the overall limit on the credit is based on a misunderstanding of the purpose of the credit. The purpose of the credit is to avoid double taxation of foreign source income. The per-country limit achieves that. Relief from taxes in excess of U.S. taxes on the same income must be sought elsewhere.

A "per country" limitation is used by most other countries that allow a foreign tax credit, and it was long used in the United States, either with the overall limitation or alone. It was repealed in 1976 because large tax accounting losses in certain countries were offsetting U.S. income and reducing revenues. Proposed changes in accounting for depreciation and for multiperiod production will largely eliminate the reasons for repealing the per country limitation. The treatment of economic losses will be addressed directly by allowing them to offset the pool of profits from all other countries, with an appropriate provision for recapture.

In combination with the reduced rate of corporate tax, the proposed changes in the foreign tax credit limitation and source rules will result in a substantial net reduction in the U.S. tax on foreign income. In effect, the combination will make the foreign tax credit operate more efficiently and equitably without penalizing foreign investment.

Another proposed change in international taxation affects the credit for income from U.S. possessions. The tax benefit of the existing credit rewards the shifting of income to the possessions, whether or not the income generated creates real economic activity there. The revenue cost of the credit is very high, and the tax saved per worker employed greatly exceeds the cost of employing that individual. In the long run, with a low-rate, broad-based tax, and the deferral of U.S. tax on the earnings of foreign corporations, the special tax preference for income from the possessions should be phased out. In the meanwhile, the credit would be revised to relate it directly to the minimum wage for employees engaged in manufacturing activities in the possessions, and to allow the credit to be used against income from any source, not only possessions source income. These proposed changes are intended to bring the incentive more into line with its purpose, as stated by the Joint Committee on Taxation, to "assist the U.S. possessions in obtaining employment-producing investments by U.S. corporations." The existing systems of taxation in effect in the U.S. territories also would be modified to resolve the inconsistencies and problems which have developed.

Finally, the taxation of income earned by foreign corporations through U.S. branches would be rationalized to bring it more into line with the taxation of income earned through U.S. subsidiaries, and certain rules concerning foreign currency transactions would be clarified.

VI. Other Tax Issues

A. Transfer Taxation

Transfers of wealth are subject to tax at the Federal level under an estate tax, a gift tax and a generation-skipping transfer (GST) tax. Transfers of wealth at death are subject to the estate tax, which is imposed at slightly progressive rates (with a large exemption level). The gift tax and the GST tax are designed on the whole to

ensure that taxpayers cannot easily avoid the estate tax through lifetime gifts, multigenerational trusts, and similar arrangements.

Ideally, the Federal transfer tax system should have as little impact as possible on the ways that individuals hold and transfer their wealth. In order to achieve this goal, the transfer tax system must be designed so that the amount of wealth that can be transferred from one individual to another net of tax does not depend on the form or timing of the transfer. This requires close coordination among the three transfer taxes as well as attention to their interaction with the income tax.

Major steps toward this goal were taken in 1976 with the unification of the estate and gift taxes and the enactment of the GST tax. Significant inequities and loopholes remain, however, leaving substantial opportunities for tax avoidance and, in some cases, resulting in double taxation. The principal thrust of the Treasury Department proposals for reform of the transfer tax system is to eliminate these inequities, thereby improving the fairness and neutrality of the system.

Perhaps the most significant of these proposals is to complete the unification of the estate and gift tax systems by conforming the computation of the gift tax base to that of the estate tax. Also of major importance is the proposal to replace the present GST tax with a new GST tax along the lines of Treasury Department's proposal of April 1983. Together, these changes will assure that the form of ownership and transfer of assets within a family will play a greatly reduced role in determining the transfer taxes paid by that family.

These proposals are approximately revenue-neutral, even though they will result in a broader transfer tax base over the longer run. However, since transfer taxes are imposed on accumulations of wealth only once in each generation, the revenue effects of the base broadening will be felt only gradually. Hence, it is not possible to propose any reduction in transfer tax rates at the present time. Once the new rules are in place and the effects of the transition rules have been phased out, rate reductions may be possible. These will make the transfer tax system an even less obtrusive factor in taxpayers' decisions as to how to hold and transfer their wealth and will further increase productivity and invention.

These proposals also permit a number of simplifications in the transfer tax system. In particular, the rules relating to when a transfer is treated as complete, when a prior gift is included in the transferor's estate, and the power-of-appointment rules can be greatly simplified. Under the proposed rules, most transfers would be subject to the transfer tax system only once in each generation, and the number of occasions when a transfer would have to be valued on the basis of actuarial tables would be significantly reduced.

One final major aspect of the transfer tax proposal relates to the timing of the payment of the estate tax. Under current law, many

estates that have adequate cash to pay the Federal estate tax are nevertheless entitled to pay the tax in installments, with a preferred interest rate applicable to part of the deferred payment. On the other hand, some truly illiquid estates are denied the right to deferred payment. The proposal would alleviate this inequity by replacing the complex test of current law with a relatively simple test allowing an estate to pay its estate tax liability in installments based on its relative holding of liquid and illiquid assets. A market rate of interest on any deferred tax payments would be charged to ensure that the expanded liquidity relief provision is fair and revenue neutral.

B. Penalties

The numerous civil penalties imposed under current law for the violation of reporting and payment provisions are complex and often inconsistent in the treatment of similar violations. Moreover, because interest is not charged, current law provides no incentive for the timely payment of penalties. The proposal consolidates many of the information-reporting penalties into one provision with uniform penalty amounts. This would simplify administration of the penalty provisions and ensure their fair application. The proposal also assesses interest on delinquent penalty amounts in order to encourage timely payment.

C. Expiring Provisions

The following special tax provisions are scheduled to expire by 1988: residential and business energy credits, the targeted jobs credit, the credit for testing orphan drugs, the special expensing rule for expenditures to remove architectural barriers to the elderly and handicapped, the exclusions of employer-provided legal services, educational assistance, and van-pooling, and the special treatment of dividends reinvested in public utility stock. The Treasury Department proposes that these provisions be allowed to expire as scheduled.

Several of these expiring provisions give preferred treatment to specific sectors, contrary to the spirit of neutrality. Others have outlived their usefulness. Most are believed to have had little effect on behavior or to provide only a weak incentive for the preferred activity. The credit for research and experimentation expenditures, however, would be extended for three years and targeted more effectively toward productivity-enhancing innovations.

D. Social Security Issues

Although the tax proposals presented by the Treasury Department deal primarily with the individual income tax, they would also have beneficial effects on the social security system. Within a few years after enactment, social security revenues would rise by about \$5 billion. The longer run impact, while harder to measure, will ultimately prove to be much more important. The increasing use of fringe benefits over the past few decades has led social security

forecasters to predict continual declines in the taxable wage base relative to total compensation paid to workers. The long-run impact on the Social Security and Disability Trust Funds (which are now nearly in long-run balance) will be minor since benefits, as well as revenues, will be increased. However, the long-run impact on the Medicare Trust Fund will be measurable, since revenues will be increased without creating additional liabilities. Moreover, the cap on the exclusion of employer-provided health insurance will help stop the upward spiral of the cost of health care. This, too, will help reduce the cost of Medicare and other government-provided health programs.

E. Items Not Included in the Tax Reform Proposal

Despite its comprehensive nature, this study proposes no change in many sections of the tax Code. In some cases, this reflects the belief that current law is appropriate. In other cases, however, changes may be desirable, but specifying the appropriate changes will require more time for detailed analysis. Therefore, the fact that no change is proposed in a particular area should not be interpreted as Treasury endorsement of current law.

This Report proposes no change in the itemized deductions for mortgage interest on the taxpayer's principal residence, medical expenses, and casualty losses. In addition, extraordinary charitable contributions would remain deductible. No change is proposed in the current provisions which exclude all or part of each of the following from tax: social security benefits; income-conditioned transfers; in-kind benefits; certain hard-to-value fringe benefits; employer-provided meals and lodging; personal injury awards; capital gains on appreciated assets transferred at death or by gift; capital gains on owner-occupied housing; earned income of U.S. citizens working abroad; and interest on state and local government bonds for "governmental" purposes. In addition, preferential tax treatment of IRAs and most retirement plans would be expanded, most employer-provided health insurance and most scholarships would remain untaxed, the earned income tax credit would be maintained and indexed, the credit for the elderly and disabled would be expanded and made available to the blind, and income averaging would still be available for most taxpayers.

Other provisions for which no changes are proposed include the following: subchapter S; corporate mergers, acquisitions, liquidations and reorganizations; export incentives (including FSC); deferral of tax on earnings of foreign corporations; rules for net operating losses; rules for pooled passive investment trusts; the accumulated earnings tax; rules for determining eligibility for the dependency exemption, marital status, and head-of-household status; related-party and attribution rules; rules governing the exemption of certain organizations from tax; and the tax treatment of cooperatives and their patrons and of partners and partnerships (except for limited partnerships with more than 35 partners).

APPENDIX 7-A

LIST OF PROPOSED REFORMS

INDUSTRY-SPECIFIC SUBSIDIES, TAX SHELTERS, AND OTHER TAX ISSUES

A. General Issues of Income Measurement

1. Match expenses and receipts from multiperiod production.
2. Restrict use of cash accounting method.
3. Limit bad debt deductions to actual loan losses.
4. Disallow installment sales treatment when receivables are pledged.
5. Repeal corporate minimum tax (only if basic reforms are fully implemented).

B. Subsidies for Specific Industries

1. Energy and Natural Resource Subsidies
 - a. Repeal windfall profits tax.
 - b. Repeal percentage depletion; use cost depletion, adjusted for inflation.
 - c. Repeal expensing of intangible drilling costs.
 - d. Repeal expensing of qualified tertiary injectant expenses.
 - e. Repeal expensing of hard mineral exploration and development costs.
 - f. Repeal special treatment of royalty income.
 - g. Repeal special rules for mining reclamation reserves.
 - h. Repeal non-conventional fuel production tax credit, alcohol fuels credit and excise tax exemption.
2. Special Rules of Financial Institutions
 - a. Commercial banks and thrift institutions
 1. Repeal special bad debt deductions for banks and thrift institutions.
 2. Disallow 100% of interest incurred to carry tax-exempt bonds by depository institutions.
 3. Repeal tax exemption of credit unions.
 4. Repeal special carryover rules, and repeal special merger rules for thrift institutions.
 - b. Life Insurance Companies
 1. Limit life insurance reserve deductions to the increase in policyholders' cash surrender value.
 2. Repeal special deduction of percentage of taxable income of life insurance companies.

3. Repeal tax exemption for certain insurance companies.
- c. Property and Casualty (P&C) Insurance Companies
 1. Limit P&C reserves to the discounted present value of future liabilities.
 2. Repeal mutual P&C insurance companies' deduction for additions to protection against loss account.
 3. Limit deductibility of P&C policyholder dividends.
 4. Repeal special tax exemption, rate reductions, and deductions of small mutual P&C insurance companies.
3. Insurance Investment Income
 - a. Repeal exclusion of investment income on life insurance policies.
 - b. Treat policyholder loans as coming first from any tax-exempt inside buildup.
 - c. Repeal exclusion of current annuity income.
4. State and Local Government Debt and Investments
 - a. Repeal the tax exemption of nongovernmental purpose tax-exempt bonds.
 - b. Tighten restrictions on tax arbitrage and advance re-funding for tax-exempt bonds.
5. Special Expensing and Amortization Rules
 - a. Repeal expensing of soil and water conservation expenditures, expenditures by farmers for fertilizer and for clearing fields.
 - b. Repeal 5-year amortization of expenditures for rehabilitation of low income rental housing.
 - c. Repeal 5-year amortization of certified pollution control facilities.
 - d. Repeal 50-year amortization of railroad grading and tunnel bores.
 - e. Repeal 5-year amortization of trademark expenses.
 - f. Repeal 84-month amortization of reforestation expenditures and 10% tax credit for such expenditures.
6. Other Specific Subsidies
 - a. Repeal rehabilitation tax credits.
 - b. Repeal special rules for returns of magazines and paperback books and for qualified discount coupons.
 - c. Repeal exclusion relating to Merchant Marine Capital Construction Fund.
 - d. Rationalize credit for research and experimentation.

C. Further Curtailment of Tax Shelters

1. Disallow most current interest deductions (with carryforward) in excess of the sum of mortgage interest on the taxpayer's principal residence, investment income, income from limited partnerships and S corporations, and \$5,000.
2. Extend at risk limitations to real estate and equipment leasing.

D. International Issues

1. Change foreign tax credit limitation to a separate per country limitation.
2. Modify rules defining source of income derived from sales of inventory-type property and intangible property.
3. Repeal the secondary dividend rule and replace with a branch profits tax.
4. Repeal special preference for 80/20 corporations.
5. Repeal possessions tax credit and replace with phased out wage credit.
6. Clarify treatment of certain transactions in foreign currency.

E. Other Tax Issues

1. Transfer Taxation
 - a. Unify estate and gift tax structure by grossing up the tax on gifts, and simplify rules for determining when a transfer is complete for gift tax purposes.
 - b. Simplify taxation of generation-skipping transfers, and modify credit for tax on prior transfers to a lower generation.
 - c. Impose a rule to prevent abuse of minority discounts.
 - d. Replace the rules governing payment of estate tax in installments with simplified rules based on estate liquidity, but make interest incurred by an estate non-deductible for estate tax purposes.
 - e. Reduce estate tax deduction for claims against an estate by the amount of income tax savings from payment of the expense.
 - f. Simplify state death tax credit by making it a flat percentage of federal estate tax collected.
 - g. Repeal special tax rules for redemption of stock to pay death taxes.
 - h. Tighten rules regarding powers of appointment.

2. Penalties

- a. Simplify information return penalties.
- b. Repeal maximum limits on penalties.
- c. Replace failure-to-pay penalty with a cost-of-collection charges.

3. Expiring Provisions

- a. Residential and certain business energy tax credits.
- b. Targeted jobs tax credit.
- c. Expensing of expenditures to remove architectural barriers to the elderly and handicapped.
- d. Credit for testing orphan drugs.
- e. Special treatment for dividend reinvestment in public utility stock.
- f. Exclusion of employer-provided legal service.
- g. Exclusion of employer-provided educational assistance.
- h. Exclusion of employer-provided van-pooling.